



CONGRESSIONAL BUDGET OFFICE MANDATES STATEMENT

January 21, 1998

S. 442

Internet Tax Freedom Act

*As ordered reported by the Senate Committee on Commerce, Science, and Transportation
on November 4, 1997*

SUMMARY

S. 442 contains no private-sector mandates, but by prohibiting the collection of certain types of state and local taxes, the bill would impose an intergovernmental mandate as defined in the Unfunded Mandates Reform Act of 1995 (UMRA). CBO cannot estimate whether the direct costs of this mandate would exceed the statutory threshold established in UMRA (\$50 million in 1996, indexed annually for inflation).

INTERGOVERNMENTAL MANDATES CONTAINED IN BILL

S. 442 would place a moratorium until January 1, 2004, on certain state and local taxes on online services, Internet access service, or communications or transactions using the Internet. The moratorium would not affect state and local taxes on these services and transactions as long as the taxes meet certain criteria in the bill. Because existing taxes are not specifically grandfathered by the bill, any current taxes that fail to meet these criteria would be preempted until the year 2004.

ESTIMATED DIRECT COSTS OF MANDATES TO STATE, LOCAL, AND TRIBAL GOVERNMENTS

Is the Statutory Threshold Exceeded?

Because it is unclear how the criteria in the bill would apply to the state and local taxes that are currently levied on Internet-related transactions or services, CBO is unable to determine

whether the threshold for intergovernmental mandates (\$50 million in 1996, indexed annually for inflation) would be exceeded in any of the first five years of the moratorium. The applicability of many of the criteria and definitions allowing for the collection of certain taxes would likely be litigated, and we cannot predict the outcome of such litigation at this time. If the criteria allowing for the collection of taxes are interpreted narrowly and if, as a result, most or all existing taxes that could be affected by this bill are suspended, the loss of revenues would probably exceed the threshold.

Total Direct Costs of Mandates

UMRA includes in its definition of the direct costs of a federal intergovernmental mandate the estimated amounts that state, local, and tribal governments would be prohibited from raising in revenues in order to comply with the mandate. The direct costs of the mandate in S. 442 would be the tax revenues that state and local governments would be precluded from collecting because of the moratorium.

Because the taxation of Internet-related services and transactions is changing rapidly, it is possible that in the absence of this legislation some state and local governments would impose new taxes or decide to apply existing taxes in this area over the next five years. (UMRA requires CBO to estimate the direct costs of a mandate for the first five years that it is effective.) It is also possible that during this time some state and local governments would repeal existing taxes or administratively limit their application to Internet-related services and transactions. These changes would affect the ultimate cost of the mandate but are extremely difficult to predict. Therefore, for the purposes of preparing this estimate, CBO limited its analysis to those taxes currently collected by state and local governments.

S. 442 would temporarily prohibit state and local governments from taxing Internet access service, online services, or communications or transactions using the Internet, unless the tax fell into one of the categories of taxes specifically preserved by the bill. These categories include:

- taxes imposed on or measured by net or gross income derived from such services,
- taxes imposed on or measured by value added, net worth, or capital stock,
- fairly apportioned business license taxes,
- property taxes,
- taxes imposed on or collected by common carriers or other providers of telecommunications service,
- franchise fees imposed on cable services, and

- sales, use, or other transaction taxes that are also imposed and collected "in the case of similar sales, uses, or transactions not using the Internet, online services, or Internet access service."

While many existing taxes would clearly fall within one of these categories and thus would be preserved, some current state and local taxes do not fit neatly in one of the categories. These taxes are sales, use, or other transaction taxes on internet access and online services and on information and data processing services. As described below, however, CBO cannot predict whether these taxes would be temporarily suspended by the bill's moratorium.

BASIS OF ESTIMATE

The moratorium in S. 442 could affect some taxes currently collected by state and local governments. For the purposes of preparing an estimate of those potential losses, CBO gathered information from 25 states and from interest groups representing both state governments and the industries that would be affected by the bill.

Taxes on Internet Access Service and Online Services. CBO has identified 12 states nationwide that currently impose a sales, use, or other transaction-based tax on the fees charged by providers of Internet access or online services. Some of those states also allow local taxes on these same services. Half of these states tax Internet access as an information or data-processing service. The other half tax Internet access as a telecommunications service. In general, states could not provide definitive estimates of their tax revenues, because many providers of these services also provide other taxable services and typically remit their tax collections to the states as one sum. In addition, the industry is growing so quickly that revenue figures from previous years are not very useful for estimating present collections. Based on the information that states could provide and on national market data, CBO estimates that 1997 revenues for the 12 states and various localities that currently collect these taxes were close to \$50 million. Given the rapid growth in use of the Internet, these revenues are likely to grow in coming years as more households and businesses decide to purchase Internet access.

It is not clear whether S. 442 would allow states and localities to continue collecting all of these revenues. The question is whether the taxes are also imposed and collected in the case of "similar sales, uses, or transactions not using the Internet, online services, or Internet access service." This question is likely to be the subject of litigation.

In the case of a sales/use tax on information and data processing services, a state wishing to preserve its tax could argue that it imposes the tax both on Internet access and on similar services not using the Internet, such as Westlaw or Lexis/Nexis. However, a provider could argue that Internet access is significantly different from access to a single data base, and that sales of Internet access should not be considered "similar sales" for taxation purposes. The same arguments could be made concerning taxes imposed on Internet access and online services as telecommunications services. It is not clear whether courts would find these services "similar" to other telecommunication services, such as telephone, fax, paging, and voice mail.

Taxes on Information and Data Processing Services. CBO also cannot predict exactly how S. 442 would affect sales, use, or other transaction-based taxes on information services or data processing services provided via the Internet or online services. For decades, companies have provided these services by allowing customers to directly connect to the companies' computers via modem. It is increasingly common, however, for firms to also provide these services over the Internet. In some cases, the companies are completely Internet-based.

A 1996 survey by the Federation of Tax Administrators identified 15 states that levy a sales, use, or other transaction-based tax on some kinds of information and data processing services. Some of those states also allow localities to levy an additional sales tax on these same services. Of those states and localities, three states and one major city were able to provide estimates of their revenue from these sources. The 1997 revenues for these jurisdictions alone were between \$35 million and \$45 million annually. As with Internet access, the market for information and data processing services provided over the Internet is growing quickly, and state tax revenues from this market are likely to follow suit. Some portion of future revenues could be interrupted by the bill's moratorium.

If S. 442 were enacted, states and localities would have to show that they tax the sales or use of information services provided via the Internet the same way that they tax "similar" sales or uses not using the Internet or online services. CBO expects that litigation would be required to determine which state and local taxes pass this test. For example, a state that levies a sales tax on the subscription that a customer pays to access news or financial information at an Internet site could argue that the tax is preserved, because it also applies to computer-based information services that do not utilize the Internet. However, the information provider could argue that its product is more similar to newspapers and magazines, which may not be subject to sales and use tax in the state.

**APPROPRIATION OR OTHER FEDERAL FINANCIAL ASSISTANCE PROVIDED
IN BILL TO COVER MANDATE COSTS**

None.

OTHER IMPACTS ON STATE, LOCAL, AND TRIBAL GOVERNMENTS

None.

ESTIMATED IMPACT ON THE PRIVATE SECTOR

S. 442 would impose no new private-sector mandates as defined in UMRA.

PREVIOUS CBO ESTIMATE

On June 18, 1997, CBO completed an intergovernmental mandates statement for S. 442, as introduced. In that estimate, we determined that the costs of the intergovernmental mandate would likely exceed the threshold established in UMRA, because that version of the bill is broader and contains language that would make it more likely that state and local governments would forgo revenues exceeding the threshold.

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